No. 87-1583

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

VERMONT DEPARTMENT OF TAXES,
Petitioner,

v.

LOREN D. KEYS AND RENETTA J. KEYS,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of Vermont

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BRIEF FOR RESPONDENTS IN OPPOSITION

ROBERT J. HIGGINS
(Counsel of Record)
GEORGE KAUFMANN
DICKSTEIN, SHAPIRO & MORIN
2101 L Street, N.W.
Washington, D.C. 20037
(202) 785-9700

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Does Rev.Stat. § 3701, as amended in 1959, exempt from State income taxation a lump sum payment received by the taxpayer which represents income derived from his investment in a separate retirement fund (qualified under I.R.C. § 401) which invests solely in U.S. Government obligations?

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STATEMENT OF THE CASE

We accept petitioner's statement of the case. In addition to the decision of the Supreme Court of Vermont quoted at Pet. 5, we set forth a portion of the Superior Court's opinion which is especially pertinent to the issue before this Court:

> The amounts contributed by both employer and Mr. Keys were invested in one or more funds at the election of, and in proportions designated by Mr. Keys. *Prospectus*, at 1 and 12. One such fund, Fund

[1] Throughout this brief, "Pet." will refer to the Petition for a Writ of Certiorari.

(A), was a fund together with the earnings thereon, invested in federal obligations. *Prospectus*, at 10. The $35,000 at issue here was interest on earned contributions attributed to Mr. Keys and invested in Fund (A). The trustee maintained a separate account for Mr. Keys, with separate records for his share in each of the funds selected by him. *Prospectus*, at 4. * * *

In essence, the Plan provided Mr. Keys an investment scheme whereby he could invest tax-free a portion of his otherwise taxable income in a choice of five investment portfolios. The character of the trust assets attributed to Mr. Keys account was irrelevant, prior to distribution, for purposes of federal and state taxation; the trust per se, as a tax-exempt entity, received no benefit from any tax-exempt or immune interest earned on investments. All incidence of income taxation, both federal and state, commenced upon taxpayers' receipt of the income.

The only substantial difference between Mr. Keys investing personally in federal securities, whose interest would be immune from state income taxation, and the transaction in question, is that the Plan grants Mr. Keys a congressionally approved method whereby both the use of and tax upon the income is deferred. Mr. Keys, not the Plan, decided to invest a portion of his contributions in federal obligations. Mr. Keys, not the plan, was the recipient of the first tax assessment on the interest earned on these federal obligations. An assessment of state income tax on that portion of the distribution was, in reality, a direct tax on interest derived from federal obligations prohibited by [Rev. Stat. § 3701]. [Pet. 18a-19a.]

REASONS FOR DENYING REVIEW

1. The Supreme Court of Vermont has ruled here and in "a companion case" (Pet. 1),[2] that Rev. Stat. § 3701,

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[2] *In re Sawyer Estate*, —— Vt. ——, —— A.2d —— (Dec. 11, 1987), reprinted at Pet. 3a-8a.

31 U.S.C. § 3124(a), exempts from State income taxation interest on federal obligations that is received by the taxpayer as a lump sum payment from an individually directed retirement fund which invests solely in federal obligations (or as a dividend from a registered investment company which so invests). Petitioner acknowledges that these decisions are in accord with the decisions of courts in six states. Pet. 8-9, citing cases. There are no contrary judicial decisions.

On March 21, 1988, this Court denied certiorari in one of the cited cases, *Illinois Department of Revenue* v. *Andras*, 56 L.W. 3647, denying review of *Andras* v. *Illinois Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E. 2d 439 (1987). The question presented by the petition in this case is identical in every material respect to that presented in *Andras*, and petitioner does not contend otherwise.[3] Nor does petitioner present anything of substance which was not before this Court when it denied review in *Andras*. Indeed, the petition in that case was supported by a brief *amici curiae* prepared by the Attorney General of Vermont and his present co-counsel.[4] Accordingly, our discussion herein will be brief.

2. The decision below (see Pet. 1a, 5a-6a), as well as the others cited at Pet. 9, followed the construction of § 3701 in *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855 (1983) ("*American Bank*"):

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[3] Here, respondent taxpayers received interest on federal obligations in the form of a lump sum payment from a retirement fund where they had designated the investments to be made. In *Andras* and *In re Sawyer Estate* (as well as the other cases cited at Pet. 9), the taxpayers received interest on federal obligations as dividends from a registered investment company (*i.e.*, mutual fund). In deciding the present case on the authority of *Sawyer Estate*, the court below treated these issues as indistinguishable, and the petition follows the same approach. We shall do likewise herein.

[4] Brief for the States of California, *et al.*, as *amici curiae*, No. 87-1142.

> The exemption for federal obligations provided by § 3701, as amended in 1959, is sweeping: with specific exceptions, it "extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation* of the tax." [463 U.S. at 862; see Pet. 5a-6a, this Court's emphasis.]

Petitioner concedes, on the authority of *American Bank*:

> The statute would prohibit, by way of example, a tax on pension income that was computed by determining the income received by the pension fund, including its income from federal obligations, and taxing each pensioner on a proportionate share of the [pension] fund's income. [Pet. 12.] [5]

Yet, petitioner argues that

> Vermont imposes a broad based tax on income earned or received by a corporation, individual, estate or trust. This income includes pensions. The tax is measured solely by the amount of income received by the taxpayer. The tax in no way considers the assets of the payor or the source of any income earned by the payor. [*Id.*]

That is a distinction without a meaningful difference. An identical argument was made to and rejected by a California court in *Brown* v. *Franchise Tax Board*, 242 Cal. Rptr. 810 (Cal. Ct. App. 1987). That court's reasoning is so apposite and lucid that it merits extensive quotation:

> The Board asserts that the tax before us is not "measured directly or indirectly" by income from federal obligations, but concerns only "dividends" paid by Companies [mutual funds] to their investors. The Board contends that this distinction flows from the general principle that "a corporation is a nonconductor that cuts off connection between dividends

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[5] Petitioner inadvertently wrote "mutual fund's".

to its stockholders and the corporate funds from which the dividends are paid." (*Miller* v. *Milwaukee* (1927), 272 U.S. 713, 714, 47 S.Ct. 280, 280, 71 L.Ed. 487.) However, this point is reminiscent of the "formal but economically meaningless" distinctions which were previously held to permit taxation of bank shareholders even if the underlying assets were federal securities—distinctions which became untenable with the 1959 amendments to the federal statute. (See *American Bank, supra*, 463 U.S. at pp. 858, 871, fn. 14, 1403 S.Ct. at pp. 3372, 3379, fn. 14.)

Moreover, as applied here, the "nonconductor" principle is less than "economically meaningless"; as a functional matter, it is wrong. The plaintiff Companies are not ordinary corporations, but registered investment companies whose business is to provide a conduit for investment in federal securities by persons who might otherwise be unable or unwilling to enter that market. The ability to pool investments in such funds stimulates the market for such securities by lowering the minimum investment necessary to participate in a given type of security, spreading the risks and rewards associated with (for example) fluctuating interest rates, and providing greater convenience and liquidity than would often be realized with individually purchased securities. Congress expressly recognized the "conductor" role of such companies when it declared, in the Investment Company Act of 1940, that they are "*media* for the investment in the national economy of a substantial part of the national savings," which "may have a vital effect upon the *flow of such savings* into the capital markets." (15 U.S.C.A. § 80a-1(a)(4) * * *.)

The constricting effect of this tax on a congressionally recognized conduit for investment capital must be weighed, together with the legislative goal of preserving the market value and investment attractiveness of federal securities, in subjecting this tax to the statutory test, i.e., whether the proceeds of federal securities are *directly or indirectly* taken

> into account in computing the tax. In this context, the [taxing authority's] claim that it is blind to the origin of the distributions paid to the plaintiff class, even if accepted, is without economic significance. Unless Congress directs otherwise, the distributions [such] companies pay to their investors must be considered as so closely identified with their source that the computation of the tax involves indirect consideration of federal obligations. [242 Cal. Rptr. at 812-813. (Court's emphasis, footnote omitted).]

The foregoing analysis not only disposes of petitioner's argument that the interest on federal obligations is not "considered directly or indirectly, in the computation of the tax," but also demonstrates why recognition of the exemption is essential to effectuate the purpose of § 3701. Petitioner does not contend otherwise with respect to either mutual funds or, as here, individually directed pension plans. Thi sis decisive, because even before the 1959 amendment to § 3701, it had been settled that the statute's purpose is "to prevent taxes which diminish in the slightest degree the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *Smith* v. *Davis*, 323 U.S. 111, 117 (1944); *N. J. Ins. Co.* v. *Div. of Tax Appeals*, 338 U.S. 665, 675 (1950).[6]

3. In asserting that the present case is important, petitioner attributes to the decisions of the court below in this case and in *Sawyer* ramifications far beyond their actual scope. It asserts that under those decisions, the states would be prohibited from taxing "dividends paid by an ordinary business corporation or interest paid on bank deposits, so long as the payee could satisfy its

[6] Insofar as petitioner seeks to limit the scope of the 1959 amendment by pointing to what the legislative history shows was the catalyst of that amendment (Pet. 12-14), it repeats an argument unsuccessfully made by petitioners in *Andras*, and, even more to the point, by respondent taxing authorities in *American Bank*. See 463 U.S. at 865-867.

burden of tracing the payment to the payor's investment in federal obligations." Pet. 10. But this argument disregards the fundamental differences between the rights of the shareholder of a corporation, and those of a shareholder in a mutual fund (or investor in an individual retirement account). See *Brown, supra.*

Petitioner goes even further, arguing that it "logically follows [from the decision below] that Vermont could also be prohibited from taxing salaries paid to employees, rent paid to a landlord, . . . if it could be shown that this income was paid with money that the payor received as interest from the federal obligations." Pet. 10.[7] Petitioner's "logic" is fallacious; the tax laws long ago solved the conundrum which petitioner poses. Notwithstanding the assignment, if the interest income were taxable, it would be taxable to the owner of the obligations (the assignor) and not to the assignee. *Helvering* v. *Horst*, 311 U.S. 112 (1940); cf. *Lucas* v. *Earl*, 281 U.S. 111 (1930). Therefore, it is the assignor alone who benefits when the interest is exempt from taxation. Neither the tax nor the exemption may be shifted. In Justice Holmes' words, the law disregards "the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115. But there is no impermissible shifting when an investor is exempted from taxation on the interest on federal obligations which he receives as a lump sum payment from his own retirement account.

4. At the close, petitioner proffers an argument which was not made in *Andras*—it seeks to analogize its position to the decisions which rejected the view that a tax on the income of a government employee is a tax on his government employer and must therefore be immune. *E.g.*, *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466

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[7] Similar hypothetical "horribles" were advanced at pp. 11-12 of the petition for certiorari in *Andras*.